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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

WILLIAM Z. SALCER, *et al.*,
Petitioners,

v.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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March 13, 1985

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QUESTION PRESENTED FOR REVIEW

In an action for damages under the antifraud provisions of the federal securities laws, are defendants entitled to offset a damage award by the amount of tax benefits realized by plaintiff-investors?

PARTIES

Petitioners – plaintiffs-appellees below – are William Z. Salcer, Panfeld, Edelman, a Texas General Partnership, Robert L. Andrews, Sanjivani C. Bakare, H.E. Chiles, Ronald Salcer, Alonzo J. Drummond, George D. Gibson, Gerald I. Green, William L. Horner, Donald V. McClarty, Stanley W. Mandel, Renato Martinez, F.J. Mikulenka, Jr., J.B. Randle, Bernard J. Sackaroff, Robert L. Scheer, Jack P. Solovy, Swanson Analysts Systems, Inc. and Bruce L. Weinberg. Swanson Analysts Systems, Inc., has no parent companies, subsidiaries, or affiliates.

Respondents – defendants-appellants below – are Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, U.S. Properties/Southwest, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow, and Blonder, Seymour & Shapss.

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No.

WILLIAM Z. SALCER, *et al.*,
Petitioners,

v.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners William Z. Salcer, *et al.*, respectfully petition this Court, pursuant to 28 U.S.C. § 1254(1) and Rule 19 of the Rules of this Court, for a writ of certiorari to the United States Court of Appeals for the Second Circuit in the case of *Salcer v. Envicon Equities*, 744 F.2d 935 (1984).

OPINIONS BELOW

The opinion of the court of appeals is reported at 744 F.2d 935 and is set forth in Appendix A. The unreported oral opinion of the district court granting the motion to strike certain affirmative defenses is set forth in Appendix E. The order of the district court dated February 2, 1984,

striking certain affirmative defenses is set forth in Appendix B. Excerpts from the transcript of oral argument before the district court on December 9, 1983, are set forth in Appendix F.

JURISDICTION

The judgment of the court of appeals reversing the district court was entered September 19, 1984. A timely petition for rehearing or rehearing *en banc* was denied on November 15, 1984, and is attached as Appendix D. On petitioners' timely motion filed February 1, 1985, this Court extended the time within which to file a petition for writ of certiorari to March 13, 1985. This Court has jurisdiction to review the decision of the court of appeals under 28 U.S.C. § 1254(1).

STATUTORY PROVISION

The following statute pertains to this case: section 28(a) of the Securities Exchange Act, 15 U.S.C. § 78bb(a), which is attached as Appendix C.

STATEMENT OF THE CASE

Petitioners are investors who purchased 15 partnership interests or units (out of 20) in Greenspoint Associates, a limited partnership that was established to build and operate a residential apartment complex called Greenspoint Project, located in Harris County, Texas, adjacent to Houston. Petitioners purchased their units between October 1977 and May 1978 at a cost per unit of $77,500. Respondents are the general partners and the accountant of Greenspoint Associates. The units were sold on the

basis of a private placement memorandum, dated October 19, 1977, and a supplemental financial analysis which included projections of tax losses, cash flow, and taxable income to be derived from the investment. Construction delays caused by the annexation by the City of Houston of the area in which Greenspoint Project is located and the consequent loss of a permanent mortgage loan commitment forced the sale of the project to an affiliate of the general partners in September 1981. Each petitioner received $30,000 per unit from the sale, resulting in a loss of $47,500. App. A, 3a-4a.

Petitioners brought suit in the Southern District of New York under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC rule 10b-5, 17 C.F.R. § 240.10b-5, seeking rescissionary damages for respondents' failure to disclose material information on the Greenspoint Project. Specifically, petitioners alleged that respondents knew or should have known, but failed to disclose to purchasers, that the City of Houston planned to annex the part of Harris County in which the Greenspoint Project was to be built; and that annexation would cause substantial increases in construction and operating costs and thereby jeopardize the permanent financing of the project. App. A, 1a, 4a.

Respondents asserted as an affirmative defense that the petitioners had each realized tax benefits from their Greenspoint investments exceeding $47,500, which respondents were entitled to offset against any damages awarded. Petitioners filed a motion under Fed. R. Civ. P. 12(c), (f), and 56 to strike the affirmative defense or grant partial summary judgment on the ground that the defense was insufficient as a matter of law. App. A, 5a.

Following oral argument, the district court granted the

motion to strike, *see* App. E, and issued an appropriate order. *See* App. B. The trial court certified the question as appropriate for interlocutory review under 28 U.S.C. § 1292(b), and respondents appealed. App. A, 6a. The Securities Exchange Commission and the Tax Division of the Department of Justice filed briefs *amici curiae* in support of petitioners.

On appeal, the United States Court of Appeals for the Second Circuit reversed. The court first pointed out that damages under the Securities Exchange Act of 1934 are governed by section 28(a), 15 U.S.C. § 78bb(a), which limits damages to "actual damages of the act complained of." *See* App. C, 23a. The court conceptually divided petitioners' investment into two components: an investment in part to realize tax benefits and in part to attain appreciation and income. Because petitioners admittedly received tax benefits, the court held that respondents' fraud injured only the appreciation and income component of the investment. Thus, to calculate "actual damages" under the 1934 Act, "all benefits [petitioners] received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages. . . ." App. A, 11a.

The court rejected arguments advanced by the SEC that tax benefits should not be deducted from defendants' damages. The SEC argued that such a rule: a) undermines the incentive for "private attorneys general" to enforce the federal securities laws; and b) renders the "government the banker for fraudulent tax shelter activity," *citing Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984). *See* App. A, 11a-12a. The court also rejected the contention put forth by the Tax Division that tax benefits realized by petitioners may be "illusory"; that the IRS may in fact

disallow them; and that, accordingly, they should be disregarded. App. A, 14a-15a.

The Second Circuit thus concluded that the motion to strike should not have been granted[1] and remanded the case. Petitioners filed a timely motion for rehearing or rehearing *en banc,* which the court denied. App. D.

REASONS FOR GRANTING THE WRIT

INTRODUCTION

This case squarely presents an issue that has never been decided by this Court: the effect of tax benefits on the measure of damages in a suit brought under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. Resolution is important because the issue may arise in virtually all federal securities litigation[2], and it is necessary because the Circuits are hopelessly divided.[3]

The decision by the court below is wrong. Neither the language, intent, or purpose of the Securities Exchange Act, nor its legislative history supports the decision. Considerations of public policy also favor a different rule. Under the Second Circuit's decision, damages resulting from the fraudulent sale of securities are mitigated to the extent there is a tax benefit, and the burden is borne by the federal government and the investors. The decision will inevitably encourage securities fraud in the sale of tax sheltered investments and deprive the federal government of taxes that it would otherwise receive from investors upon their receipt of damages from fraudfeasors.

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[1] *See* pp. 6-7, *infra.*

[2] The issue will also arise in private suits brought under the Commodity Exchange Act. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran,* 456 U.S. 353 (1982)

[3] *See* pp. 13-14, *infra.*

The Second Circuit decision will require the courts, juries, and parties in virtually every securities fraud case to engage in a prior evaluation of the tax returns of plaintiffs, violate the confidentiality of tax returns, and speculate upon the tax treatment to be accorded to plaintiffs by the IRS. The court below should have applied the "collateral source" rule which traditionally has been applied to the assessment of damages in tort and fraud cases. Under this rule, benefits received by plaintiffs from third parties are not credited against the defendant's liability.

ARGUMENT

Before addressing the merits of this case, the court of appeals' contention that the trial court improperly used the motion to strike under Fed. R. Civ. P. 12(f) must be considered. The appellate court applied the rule that motions to strike are not favored and held that in this case "there exist material issues that can only be resolved after the facts are known." App. A, 18a. It is true that motions to strike are not generally favored. *See* 5 C. Wright & A. Miller, *Federal Practice & Procedure* § 1381 (1969). It is equally true, however, that under the Federal Rules of Civil Procedure how a motion is labeled or characterized by the moving party is of "little importance" in determining how a court treats the motion. *Id.* § 1380. The Second Circuit, among other courts, has approved treating a motion to strike as a motion for summary judgment if accompanied by supporting documents. *Ciprari v. Servicos Aereos Cruzeiro,* 245 F. Supp. 819, 820 (1965), *aff'd,* 359 F.2d 855 (1966). Moreover, petitioners filed their motion under rule 56, as well as rule 12(f). App. A, 5a.

The facts relevant to petitioners' motion to strike are not in dispute. The trial court accepted stipulations of counsel

based on documents submitted by respondents as the factual basis or record upon which to adjudicate the motion. *See* App. F, 33a-35a. Stipulations of counsel, like admissions, are binding on the party offering them and may properly provide the factual predicate for a motion for summary judgment. Fed. R. Civ. P. 56(c); *see, e.g., Glick v. White Motor Co.*, 458 F.2d 1287, 1291 (3d Cir. 1972); *Haberman v. Murchison*, 468 F.2d 1305, 1315 (2d Cir. 1972); *In re Georgia Jewelers, Inc.*, 219 F. Supp. 386, 391 (N.D. Ga. 1962). Thus, the trial court made it clear that with the stipulations of counsel, he was treating the motion to strike as one for summary judgment. "[F]orget about whether it's for a motion to strike affirmative defenses or not. . . . There is a pure question of law with that underpinning of facts, and it's just like a motion for summary judgment addressed to an affirmative defense." App. F, 36a.

In short, the "facts" that the court of appeals believes need to be "resolved," App. A, 18a, are material only because the court rejected the trial court's legal holding concerning the tax benefit offset rule. Had the court of appeals accepted the trial court's legal conclusion – the issue now before this Court – it could have no objection to the procedure followed by the trial court.

In addressing whether tax benefits must be taken into account in assessing damages under the Securities Exchange Act of 1934,[4] "the starting point," as this Court

[4]Resolution of the tax offset question presented by this case in the context of the 1934 Act would apply as well to the Securities Act of 1933. Although the 1933 Act has no provision comparable to section 28 of the 1934 Act, the courts measure damages under both Acts in similar fashion. *See generally*, III L. Loss, *Securities Regulation* 1721 (2d ed. 1961).

has enjoined, "is the language [of the statute] itself." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 197 (1976). Section 28(a) provides in relevant part:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . .

15 U.S.C. § 78bb(a); *see* App. C, 23a. From the phrase "actual damages," the court of appeals concluded that tax benefits received by a plaintiff must be deducted from any judgment because they represent "real economic value mitigating any loss. . . ." App. A, 9a.

This contention, however, begs the question of what the 1934 Act intended by the description "actual damages." The structure of section 28(a) suggests that the limitation of damages to "actual damages" is to prevent duplicative recovery by plaintiffs asserting claims in different forums and to exclude speculative damages from any recovery.

The first sentence of section 28(a) provides that the rights and remedies provided by the Securities Exchange Act are "in addition to any and all other rights and remedies that may exist at law or in equity." The purpose of this sentence is to make clear that federal remedies do not pre-empt remedies that may exist under state laws. The phrase "actual damages," which immediately follows in section 28(a), is thus designed to prevent a plaintiff from recovering more than once for the same violation or cause of action. *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d

Cir. 1981). The Act's legislative history provides no additional insight into the legislative intent.

Under these circumstances, the courts have relied on "practical factors" and "policy considerations" to explicate the intent of Congress. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975). All practical and policy considerations favor excluding tax benefits in the calculation of damages.

Underlying the court's decision is the unarticulated assumption that the tax benefits received by a plaintiff-investor are attributable to the defendant, which must be accounted for when damages are calculated. This assumption is false. Tax benefits are granted by the government, not the developer; the level of these benefits is determined by the plaintiff-investor's tax situation, not that of the developer. *See Hayden v. McDonald,* 742 F.2d 423, 442 (8th Cir. 1984) (Lay, J., concurring). Moreover, the receipt of tax benefits is not related in any way to any act of the developer.[5] By crediting to the defendant benefits conferred by the government, the court of appeals' rule effectively brings about a transfer of funds from the government to the defendant. In the colorful phrase of the Ninth Circuit, the "government [becomes] the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp., supra*, 727 F.2d at 838.

Three harmful effects follow from the court of appeals' decision in this case. First, in all securities fraud cases, the

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[5]The court of appeals correctly observed that "the investor normally pays a higher price for a tax shelter than for one involving simply future growth or income." App. A, 10a. What the court failed to point out is that the incremental cost of a tax shelter investment over one offering no tax shelter simply increases the promoter's profits.

rule will reduce a defendant's damages. In many instances – particularly where as in the case at bar the investment is induced and promoted by tax laws designed to further socially desirable goals – the court's rule may eliminate damages altogether. The policies of encouraging certain types of investments and discouraging securities fraud are not served when those who commit fraud escape sanctions.

The decision in this case would do violence to the rule prohibiting fiduciaries from profiting from transactions with their beneficiaries. By hypothesis, the general partners in this case committed fraud. Yet the decision below would allow them to escape responsibility and reap the tax benefits intended by Congress to benefit those who risk their capital in investments deemed socially useful. As this Court observed in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, the Congress "made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like." 404 U.S. 6, 10-11 (1971) (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6).

The second effect of the decision below is to reduce government revenue and to bring the government into the fraudulent transaction to assist those committing the fraud. *See Western Federal Corp. v. Davis,* 553 F. Supp. 818, 821 (D. Ariz. 1982), *aff'd sub nom. Western Federal Corp. v. Erickson,* 739 F.2d 1439 (9th Cir. 1984). The court's analysis accounts for only a portion of the tax consequences of the transaction: the tax benefits that the plaintiff received. In fact, a complete account of those consequences must include not only the tax benefits received by the plaintiff, but the government's later capture, as

ordinary income, of a portion of the damages received by plaintiffs. 1 J. Mertens, *Law of Federal Income Taxation,* § 7.34.

Third, the rule adopted by the Second Circuit will cause serious adjudicatory problems. If tax benefits are a factor in the award of damages, plaintiffs will have to submit their otherwise confidential tax returns to the scrutiny of other parties, the court, and jury. *See* 26 U.S.C. § 6103(a) (prohibiting unauthorized disclosure of tax returns or tax return information); 26 U.S.C. § 7431 (civil damage remedy for unauthorized disclosure of tax returns or tax return information).

Even when a litigant's income is legitimately at issue, the courts are reluctant to allow the discovery of tax returns. *E.g., Payne v. Howard,* 75 F.R.D. 465, 469-70 (D.D.C. 1977) ("policy against disclosure applies with equal force to protect tax returns in the hands of private litigants"). When the litigant's taxable income is merely a collateral issue — as it surely is in a federal securities case — the confidentiality policy would be seriously compromised if a defendant could routinely discover the plaintiff's tax returns.

Even worse than discovery by the defendant, a plaintiff would have to contemplate that in a trial to recover damages for securities fraud his tax filings may become public. A defendant might challenge a plaintiff's return in order to lower his damages, thus defeating the purpose of any protective order restricting access that a court might otherwise grant during discovery. Indeed, at least one court has expressly decided that the court and jury may examine the plaintiff's tax returns when adjudicating damages under section 10(b) of the 1934 Act. *Austin v.*

Loftsgaarden, 675 F.2d 168, 183 (8th Cir. 1982), *en banc reconsideration granted*, Oct. 17, 1984.

Subjecting tax returns to the scrutiny of litigants is thoroughly inappropriate in securities cases, defeats the purposes that the confidentiality provisions of the Internal Revenue Code are designed to promote, and will discourage parties from seeking relief from fraud under the federal securities acts. Moreover, it is doubtful that there can be any recovery at all until tax issues, including those unrelated to the securities fraud, are resolved. It is impossible to determine the tax bracket of a plaintiff until his return has been finally accepted. The court's rule would, contrary to public policy, tend to keep litigation open and reduce the certainty of the law.

The Second Circuit rule would also create anomalous damage awards. Plaintiffs in different tax brackets, but in all other respects identically situated with respect to the investment at issue, would receive different damages. Disparate treatment of investors based upon their taxable income undermines the purposes of the federal securities laws. *See Herman & MacLean v. Huddleston,* 459 U.S. 375, 390 (1983).

The issue presented in this case in the context of the federal securities laws commonly arises in tort cases: whether insurance benefits or other payments received by a plaintiff should reduce an award of damages. Through invocation of the so-called "collateral source" rule, courts almost universally have adopted a rule contrary to the rule chosen by the court of appeals in this case. *E.g., Hall v. Chicago & North Western Ry.,* 5 Ill.2d 135, 151, 125 N.E.2d 77, 86 (1955).

As set forth in the Restatement (Second) of Torts § 920A(2):

> Payments made to or benefits conferred on the injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The commentary states that a "benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor. . . . If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers." *Id.* Comment b. The tax benefits received by petitioners are comparable to benefits subject to the collateral source rule. They are received from a third party or established by law. The policies that support the exclusion of collateral sources in the tort area apply *a fortiori* when the tort involves, as in this case, intentional fraud.

The importance of resolving the issue presented – because it arises in virtually every securities fraud case – is clear.[6] In addition, however, the Circuits are at odds on the question. Joining the Second Circuit is the Fifth Circuit. *Bridgen v. Scott,* 456 F. Supp. 1048, 1061 (S.D. Tex. 1978); *see Dupuy v. Dupuy,* 551 F.2d 1005, 1024-25 (5th

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[6]The court below emphasized both the importance of the question presented by this case and the disagreement among courts of its proper resolution.

> The legal issue on the present appeal is substantial and disputed. We have never addressed the question of whether, in an action alleging fraud with respect to a tax shelter investment, the plaintiff's recovery must be reduced by tax benefits received. Those courts considering the question have reached differing conclusions. Thus the law on this point is confused and unsettled.

App. A, 8a (citations omitted). The involvement of two government agencies, the SEC and the Tax Division of the Justice Department, in the proceedings below highlights the public importance of this issue.

Cir. 1977). The Seventh and Ninth Circuits, by contrast, have adopted the rule that damages should not be reduced by the tax benefits received by a plaintiff. *Spatz v. Borenstein,* 513 F. Supp. 571, 586 (N.D. Ill. 1981); *Burgess v. Premier Corp., supra; Western Federal Corp. v. Erickson,* 739 F.2d 1439, 1444 (9th Cir. 1984). The Eighth Circuit is itself divided. *Compare Hayden v. McDonald, supra* (damages not reduced by tax benefits), *with Austin v. Loftsgaarden, supra* (damages reduced by tax benefits), *en banc reconsideration granted,* Oct. 17, 1984.[7] However the Eighth Circuit resolves the issue *en banc,* the division among the Circuits will remain. This Court should resolve the conflict and review the decision below.

[7]Both the SEC and the Tax Division of the Department of Justice have filed briefs *amici curiae* in *Austin*, requesting the Eighth Circuit to overrule the panel decision.

CONCLUSION

For the reasons stated, this Court should grant the writ of certiorari to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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March 13, 1985

APPENDIX A

WILLIAM Z. SALCER, PANFELD, EDELMAN, et al., a Texas General Partnership, Robert L. Andrews, M.D., Sanjivani C. Bakare, M.D., H.E. Chiles, Ronald Salcer, Alonzo J. Drummond, M.D., George D. Gibson, Gerald I. Green, M.D., William L. Horner, Donald V. McClarty, Stanley W. Mandel, Renato Martinez, M.D., F.J. Mikulenka, Jr., J.B. Randle, Bernard J. Sackaroff, Robert L. Scheer, Jack P. Solovy, Swanson Analysts Systems, Inc. and Bruce L. Weinberger, M.D., Plaintiffs-Appellees.

v.

ENVICON EQUITIES CORP., Envicon Development Corp., Envitex Realty Corp., Venture Development Group Inc., a Texas Corporation, U.S. Southwest Associates, a Texas General Partnership, U.S. Properties/Southwest, a Texas General Partnership, Turning Block Associates, a New York Limited Partnership, Feit & Ahrens, a New York Partnership, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss, a New York Partnership, Defendants-Appellants.

Nos. 1340, 1455-1458, Dockets 84-7183, 84-7185, 84-7187, 84-7189, 84-7191.

United States Court of Appeals,
Second Circuit.

Argued June 18, 1984.

Decided Sept. 19, 1984.

Before MANSFIELD, MESKILL and CARDAMONE, Circuit Judges.

MANSFIELD, Circuit Judge:

In this action in the Southern District of New York under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b),[1] and S.E.C. Rule 10(b)5, 17 C.F.R. § 240.10b-5,[2] plaintiffs seek rescissionary damages for defendants' alleged failure to disclose material information relating to a real estate tax shelter in which the plaintiffs invested. Having been granted an interlocutory ap-

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[1] "§ 78j. Manipulative and deceptive devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[2] "§ 240.10b-5. Employment of manipulative and deceptive devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

peal pursuant to 28 U.S.C. § 1292(b),[3] defendants challenge the order of Judge Vincent L. Broderick granting plaintiffs' motion to strike defendants' affirmative defense to the effect that any damages must be reduced by the amount of tax benefits admittedly realized by the plaintiffs. Judge Broderick ruled that the defense was inadequate as a matter of law. We reverse.

Plaintiffs are purchasers of 15 partnership interests ("units") in Greenspoint Associates, a limited partnership established to construct, own and operate a residential apartment complex known as "the Greenspoint Project." Defendants are the general partners of Greenspoint Associates and their affiliates, accountants, and attorneys. Plaintiffs purchased their units for $77,500 each between October 1, 1977 and April 30, 1978, based in part on sales literature including an October 1979 Private Placement Memorandum and projections included in a financial analysis dated October 19, 1977. The literature indicated that Greenspoint Associates was a Texas limited partnership and that the Greenspoint Project was to be a 308-unit multi-family rental complex located in Harris County, Texas, outside of the Houston city limits. Although the Private Placement Memorandum is not part of the record, portions of it were annexed to an affidavit in opposition to plaintiffs' motion to strike. The memorandum stated:

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[3] "(b) When a district judge, in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order. The Court of Appeals may thereupon, in its discretion, permit an appeal to be taken from such order. . . ."

> "[I]nvestment in the Units is suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment. Only persons whose income is subject to high rates of income taxation will derive the full economic benefit of the intended tax benefits of this offering."

Plaintiffs alleged in the first count of their Amended Complaint that defendants knew or should have known, and failed to disclose, that the City of Houston was planning to annex that part of Harris County in which the Greenspoint Project was to be built. According to plaintiffs, annexation could be expected to cause a marked increase in the costs of building and operating the project because of (1) the imposition of water, sewer and building permits, certificates of occupancy, sales tax and real estate taxes, (2) additional construction requirements such as water and sewer utility lines, landscaping and sidewalks, (3) additional roofing, plumbing and electrical work needed to comply with Houston's building code, and (4) a delay in the project's completion that would jeopardize the permanent financing described in the sales literature. The City of Houston did annex the area and a forced sale of the premises occurred in September 1981. Each plaintiff received $30,000 per unit as a result of the forced sale and claims a net investment loss of $47,500 per unit. Since the forced sale rendered rescission impossible, plaintiffs seek the latter amount per unit as rescissionary damages.

Each defendant included in the answer to the complaint an affirmative defense, asserting that plaintiffs had realized tax benefits stemming from their investment that were in excess of their claimed loss of $47,500. The defenses were premised on the assumption that each plaintiff was taxed at a marginal rate of at least 50% during the years

1977 through 1981, an assumption that plaintiffs do not challenge. There has not, however, been any discovery of the actual tax consequences for each plaintiff.

On August 29, 1983, plaintiffs moved for an order pursuant to Fed.R.Civ.P. 12(c), 12(f), and/or 56, to strike these affirmative defenses. Oral argument on the motion was held on December 9, 1983, at which time the parties stipulated that tax benefits were a factor in plaintiffs' decision to purchase their units and that defendants' calculations showing tax benefits to each plaintiff exceeding the $47,500 were correct. Defendants sought discovery for the purpose of proving that "with one or more plaintiffs the sole reason they got into this investment was because of the tax benefits." The district court agreed that "a desire for very extensive tax deductions was a primary motivation for people to invest here, because the whole thrust of the offering letter or the document was to that effect." However, Judge Broderick granted the Rule 12(f) motion to strike at the close of oral argument.

The district court reasoned that although "tax considerations come into this case in determining whether there was in fact a fraud committed," there were effectively two investments at issue: "One was the opportunity to receive currently available but probably rapidly wasting tax benefits or tax deductions or tax shelters. The second part of the bargain was an investment in a capital resource that ultimately they, the [plaintiffs], expected to increase in value" and to "ultimately produce income." The allegations of fraud, said the court, pertained only to the latter aspect of the investment; there had been no claim of fraud with respect to the tax consequences of the Greenspoint Project. The district court then concluded that it "makes no sense to say that any loss to the defrauded investor and

hence, any gain or recovery which he is entitled to should be reduced by the tax benefits that he has realized," stating:

> "Those tax benefits would have been realized whether or not there was a fraud in this particular situation.
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> * * * * * *
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> "The investor who was interested in tax considerations when he invested here could very well have invested in some entirely different company, realized comparable tax benefits, and not suffered the loss that the investors here are alleged to have suffered because of the fraud."

Judge Broderick stressed that the defendants would still be permitted to explore plaintiffs' tax shelter considerations in order to show that these were their prime motivations and that they did not rely on the defendants' alleged fraudulent omissions with respect to annexation of the site by the City of Houston. Since the issue of whether any recovery must be reduced by the amount of tax benefits was critical, plaintiffs having represented that if they received an adverse ruling on that issue they would drop their suit, the district court certified the issue as appropriate for interlocutory review under 28 U.S.C. § 1292(b).

DISCUSSION

A motion to strike an affirmative defense under Rule 12(f), Fed.R.Civ.P. for legal insufficiency is not favored and will not be granted "unless it appears to a certainty that plaintiffs would succeed despite any state of the facts which could be proved in support of the defense." *Durham*

Industries, Inc. v. North River Insurance Co., 482 F.Supp. 910, 913 (S.D.N.Y.1979) (quoting *Lehmann Trading Corp. v. J. & H. Stolow, Inc.*, 184 F.Supp. 21, 23-23 (S.D.N.Y.1960)). *See Mohegan Tribe v. State of Connecticut*, 528 F.Supp. 1359, 1362 (D.Conn.1982); *Meinrath v. Singer Co.*, 87 F.R.D. 422, 429 (S.D.N.Y.1980); *Wellman v. Dickinson*, 79 F.R.D. 341, 349 (S.D.N.Y.1978); *Sample v. Gotham Football Club, Inc.*, 59 F.R.D. 160, 168 (S.D.N.Y.1973); *Carter-Wallace, Inc. v. Riverton Laboratories, Inc.*, 47 F.R.D. 366, 367 (S.D.N.Y.1969). Moreover, even when the facts are not disputed, several courts have noted that a "motion to strike for insufficiency was never intended to furnish an opportunity for the determination of disputed and substantial questions of law." *Carter-Wallace, Inc. v. Riverton Laboratories, Inc., supra*, 47 F.R.D. at 367-68 (quoting *Budget Dress Corp. v. International Ladies' Garment Workers' Union*, 25 F.R.D. 506, 508 (S.D.N.Y. (1959)); *see also Augustus v. Board of Public Instruction*, 306 F.2d 862, 868 (5th Cir.1962); *Mohegan Tribe v. State of Connecticut, supra*, 528 F.Supp. at 1362; *Wellman v. Dickinson, supra*, 79 F.R.D. at 349; *Systems Corp. v. American Telephone & Telegraph Co.*, 60 F.R.D. 692, 694 (S.D.N.Y.1973). This is particularly so when, as here, there has been no significant discovery.

"[E]ven when the defense presents a purely legal question, the courts are very reluctant to determine disputed or substantial issues of law on a motion to strike; these questions quite properly are viewed as determinable only after discovery and a hearing on the merits." 5 C. Wright & A. Miller, *Federal Practice & Procedure* § 1381, at 800-01 (footnotes omitted). To do otherwise would be to run the risk of offering an advisory opinion on an abstract and hypothetical set of facts. *See Lunsford v. United States*,

570 F.2d 221, 229-30 (8th Cir.1977). *Accord Green Mountain Power Corp. v. General Electric Corp.*, 496 F.Supp. 169, 171 (D.Vt.1980); *S.E.C. v. Gulf & Western Industries*, 502 F.Supp. 343, 347 (D.D.C.1980); *Sample v. Gotham Football Club, supra*, 59 F.R.D. at 169; *Wellman v. Dickinson, supra*, 79 F.R.D. at 351.

The legal issue on the present appeal is substantial and disputed. We have never addressed the question of whether, in an action alleging fraud with respect to a tax shelter investment, the plaintiff's recovery must be reduced by tax benefits received. Those courts considering the question have reached differing conclusions. *Compare Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir.1984) (not requiring reduction) *with Austin v. Loftsgaarden*, 675 F.2d 168, 180-84 (8th Cir.1982) (requiring deduction). Thus the law on this point is confused and unsettled. For reasons set out below, further facts must be obtained before the issue can definitively be resolved in this case. It was therefore error to strike the affirmative defenses.

In deciding what damages may be recovered for fraud in violation of the Securities Exchange Act we are governed by § 28(a), 15 U.S.C. § *78bb(a)*,[4] which limits damages in a civil suit based on violation of the Act to "ac-

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[4] "(a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . ."

tual damages on account of the act complained of." As we stated in *Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir.1981):

> "[T]he purpose of section 28(a) is to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act, whether the measure of those compensatory damages be out-of-pocket loss, the benefit of the bargain, or some other appropriate standard."

"Actual damages," as used in the Exchange Act, means "compensatory damages," *id.,* and hence a plaintiff cannot recover more than his or her "net economic loss." *Marbury Management, Inc. v. Kohn,* 470 F.Supp. 509, 516 (S.D.N.Y.1979), *aff'd in part, rev'd in part,* 629 F.2d 705 (2d Cir.), *cert. denied,* 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980). It is not within our power to ignore benefits bargained for and received by plaintiffs as a result of the transaction at issue, which represent real economic value mitigating any loss they may have suffered.

One of the prime motivations for investment in limited real estate partnerships is the unique tax advantage made available to high tax bracket individuals. The partnership as an entity is not subject to taxation. It serves as a conduit through which partnership losses are passed on to the partners, thus providing a shelter to offset the investor's other taxable income to the extent of the adjusted basis of the investor's interest in the partnership. *See Austin v. Loftsgaarden, supra,* 675 F.2d at 173; Note, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud,* 63 Va.L. Rev. 669, 673 (1977). Indeed, in some such partnerships the investor's potential deductible losses may be increased, at least for a few years, to a point equalling the partner's original invest-

ment through use of accelerated depreciation methods, prepayment of mortgage interest, legal and accounting fees, commitment fees incurred in obtaining financing to buy the mortgage property, and the like, with taxation on any gain deferred until the investment is liquidated. *Id.* at 672-75. Even assuming that the investor's ultimate goal is to realize a gain from an income-producing business (either through sale or income), the intervening tax benefits to the partner represent an important tangible economic advantage expected to be derived from his investment regardless whether the venture eventually operates at a profit. The importance of this aspect of the investment is recognized in decisions awarding damages for failure of the tax advantages of shelters to live up to the seller's representations. *See, e.g., Sharp v. Coopers & Lybrand,* 649 F.2d 175 (3d Cir.1981) (holding accounting firm liable for acts of employee in preparing tax opinion letter), *cert. denied,* 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982). In short, the investor normally pays a higher price for a tax shelter investment than for one involving simply future growth or income. *See* 4 R. Haft & P. Fass, *Tax Sheltered Investments,* Intro-8 to 9 (3d ed. 1981).

In the present case the district court took the view that at least a portion of plaintiffs' investment was made to realize tax benefits and the balance with a view to an income or appreciation potential.[5] Even given this theory,

[5]Upon appeal the SEC as amicus curiae takes the same view, stating (1) that "There is no claim in this case that the fraud undermined the legitimacy of the tax shelter treatment," SEC Brief 4, note 3, (2) that normally the purchase price includes "a premium representing the opportunity to obtain future tax benefits," *id.* 8, and (3) that "since the allegations of fraud relate only to the investment aspects of the project and there is no claim that the fraud affected the price paid for the tax shelter feature, the defendants would be liable in out-of-pocket damages only for the investment loss and would retain the initial premium paid for the right to future tax benefits," *id.,* 9.

the $77,500 investment in each unit, to the extent that it was paid for the opportunity to secure tax benefits, would not be rescindable since plaintiffs realized all of the tax benefits for which they bargained. Thus, using the district court's theory, it was error to grant the motion to strike without first making a factual determination of the allocation of the purchase price between the tax and appreciation components. To the extent that plaintiffs invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any, to which they would be entitled.

Plaintiffs, joined by the Securities and Exchange Commission appearing as *amicus curiae,* argue that the district court's striking of the defense was proper because by refusing to "give the defendants credit" for tax benefits received by the plaintiffs it created an additional incentive for "private attorneys general" to file civil suits based on the securities laws. Regardless of the accuracy of that assumption, it is not for us but for Congess to create such incentives, *see, e.g., Alyeska Pipeline Service Co. v. Wilderness Society,* 421 U.S. 240, 263, 95 S.Ct. 1612, 1624, 44 L.Ed.2d 111 (1975) (shifting of attorneys fees by court to create incentive is impermissible), and Congress has demonstrated that it knows how to deter and punish securities fraud by enacting a series of laws authorizing proceedings without proof of actual damage required by Rule 10b-5, e.g., proceedings by the SEC and IRS, either in court or by administrative action, to enjoin fraudulent conduct or obtain disgorgement; criminal prosecutions and actions for civil fines. *Cf. Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975). We are barred from engaging in judicial legislation

by § 28(a) of the Exchange Act, which limits plaintiffs to recovery of their actual net economic loss and does not give us discretionary power to increase that amount in order to encourage the filing of private damage actions. In applying § 28(a) we cannot ignore the substantial economic tax benefits bargained for and realized by plaintiffs.

Nor can we agree with the notion that our ruling makes "the government the banker for fraudulent tax shelter activity," *Burgess v. Premier Corp., supra,* 727 F.2d at 838. As Judge Broderick noted, there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

For the same reasons plaintiffs' argument that defendants are not entitled to "credit" for the tax benefits because the latter were "provided" by the government rather than by the defendants must be rejected. The standard established by § 28(a) for determining the amount of damages to be awarded is not the egregiousness of the defendants' conduct but the extent of plaintiffs' actual injury. To ignore the sizeable tax benefits actually realized by the plaintiffs would be unrealistic. There is nothing improper or unusual in taking tax considerations into account in determining the amount of damages to be awarded. *See Norfolk & Western Railway Co. v. Liepelt,* 444 U.S. 490, 100 S.Ct. 755, 62 L.Ed.2d 689 (1980); *O'Connor v. United States,* 269 F.2d 578 (2d Cir.1959).

In an effort to avoid being credited with their realized tax benefits resulting from their investment in the tax shelter plaintiffs, joined by the S.E.C., argue that the tax benefits here should fall within the "collateral source" rule, which prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insurance policies negotiated independently. Restatement (Second) of Torts § 920A(2) (1979). A classic example is the court's ruling in a personal injury action that a plaintiff's recovery is not to be reduced by any insurance proceeds received under his independent insurance policy in which the defendant played no part.

The essence of the collateral source rule is the independence of the transaction giving rise to the collateral source, such as the insurance policy. Here, in contrast, the tax benefits, although paid by the government, emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award. *See* Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Geo.L.J. 1093, 1159-60 (1977). Indeed, the SEC has recognized that tax benefits are an inextricable part of real estate limited partnership tax shelter offerings by issuing Guidelines (e.g., SEC Guideline 60, which was in effect during the relevant period in this case) requiring the issuer to disclose the prospective tax benefits that might be realized from the investment. The fact that the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them. To hold otherwise would be to confer an undeserved windfall upon the plain-

tiffs. Assuming proof that the $77,500 investment per unit was induced by fraud, not only would they retain the $97,866 per unit already received ($30,000 upon liquidation plus $67,866 tax savings) but they would gain another $47,500 (i.e., the difference between the $77,500 paid per unit and the $30,000 per unit received upon liquidation) for a total of $145,366.

The SEC's further argument that the plaintiffs' tax benefits should not be offset against their damages because the benefits are equivalent to pre-judgment interest must be rejected out of hand. The suggestion that net tax benefits of $63,866 received by the plaintiffs during the period 1977-81 on their investment of $77,500 for the period 1977-79 amounts to pre-judgment interest is so unrealistic and disproportionate as to border on the frivolous. If any pre-judgment interest is due in the present case, the amount can be calculated by the district court. Treatment of tax benefits as interest, aside from being fictional, would be wholly unnecessary.

The Tax Division of the U.S. Department of Justice, also appearing as amicus curiae in opposition to reduction of plaintiffs' recovery by the amount of the tax benefits, does not go as far as the SEC and plaintiffs, both of whom contend that tax benefits should be disregarded as a matter of law in calculating damages recoverable under § 28(a) of the Exchange Act. The Tax Division argues instead that the district court's ruling should be affirmed because the tax benefits in any given case may prove to be illusory: "Depending upon the circumstances of each case, the Internal Revenue Service may challenge the original deductions, the tax treatment required upon sale or other disposition of the investment, and the tax treatment of any damages recovered, all of which may cancel, in whole or in

part, prior tax benefits." Brief at 5. This was the rationale used by the Ninth Circuit in *Burgess v. Premier Corp., supra,* and by the district court in *Western Federal Corp. v. Davis,* 553 F.Supp. 818 (D.Ariz.1982), *aff'd sub nom. Western Federal Corp. v. Erickson,* 739 F.2d 1439 (9th Cir.1984).[6] However, the mere possibility that the I.R.S. may later challenge the plaintiffs' tax benefits is not sufficient for us at this stage of the litigation simply to ignore those benefits. There must first be some showing of facts *in this case* that would justify such a challenge by the I.R.S. So far the government has not pointed to any evidence indicating that the tax benefits were improperly claimed by plaintiffs or that they will be recaptured or offset. None of the immediate parties to this litigation question the legality or amount of the tax benefits.

Despite the fact that plaintiffs took the deductions during the period from 1977-81, thereby giving the I.R.S. several years to challenge them, it has not sought to disallow them. Indeed, the government merely speculates that it "*may*" challenge them some time in the future and that it is possible that they "*could* be denied in whole *or in part*" (emphasis added). Brief at 5. Ignoring its own inaction in the matter the I.R.S. objects to the suggestion that the court might evaluate the issue in this litigation (the course taken by the 8th Circuit in *Austin v. Loftsgaarden, supra,* where an I.R.S. audit was already in progress) on the ground that the court would be "second-guessing" whether and to what extent the tax shelter deductions might be disallowed by the I.R.S. We disagree. The gov-

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[6]Although the plaintiffs cite this court to the results in *Burgess* and *Western Federal Corp.,* they nevertheless reject the rationale of those decisions. The plaintiffs share the defendants' view that the tax benefits are not illusory.

ernment's equivocal position on the issue leaves nothing to be second-guessed. If the I.R.S.'s position is that the plaintiffs are not entitled to the tax benefits they took, its duty is to disallow the deductions rather than attempt to place the issue in limbo indefinitely. Despite ample time for an audit and initial decision it has failed to act.

The government's next argument, that tax losses claimed and taken by the plaintiffs during the Greenspoint Project's early years would be subject to "recapture" by the I.R.S. upon sale of the apartment project at any time prior to expiration of its service period, needs little discussion. Since the building was in fact sold at a substantial loss in 1981, any recapture would already have occurred. Provisions requiring a portion of the gain upon sale to be treated as ordinary income, *see Commissioner v. Tufts,* 461 U.S. 300, 103 S.Ct. 1826, 1829 n. 2, 75 L.Ed.2d 863 (1983), therefore have no application to this case.

Another theory offered by the Justice Department's Tax Division, the "tax benefit doctrine," is equally unpersuasive as a ground for not taking the tax benefits realized by plaintiffs into account in calculating their damages. Under the "tax benefit doctrine" a taxpayer who claims a deduction resulting in a tax benefit for one year and then later obtains a recovery or repayment that is inconsistent with the premise underlying the deduction must include the recovery in ordinary income. *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S.Ct. 1134, 75 L.Ed.2d 130 (1983). The government argues that any rescissionary damages recovered by the plaintiffs would be the equivalent of full rescission of their original purchase, putting them in the same position as if they had never owned the tax shelter investment, and that since such recovery would therefore be inconsistent with their claim-

ing deductions as owners the deductions would be offset by income taxes due on their recovery in this action.

The contention that the tax benefit doctrine applies to this case suffers from some basic misconceptions. It fails to distinguish between actual rescission, which is impossible in this case because of the forced sale of the project, and rescissionary damages, which are not the same as rescission and may be awarded when actual rescission is unavailable. *See* 5C A. Jacobs, *Litigation and Practice under Rule 10b-5,* § 260.03(c)(vi)(a) (1984). If this were a case of actual rescission such as *Burgess v. Premier Corp., supra,* which is distinguishable on that ground, the tax benefit doctrine might apply, as was held in that case. In that event, however, the plaintiffs would not be required to amend their prior years' tax returns to eliminate the deductions taken (which the *Burgess* court erroneously assumed) but to report the money judgment later recovered as taxable income. See *Hillsboro National Bank v. Commissioner, supra;* J. Mertens, 1 *Law of Federal Income Taxation* § 7.37. If the district court in the present suit for rescissionary damages concluded, as it would have the power to do, that the tax benefits should be offset against the $47,500 damages claimed, the remedy, although labelled "rescissionary" damages, would not be inconsistent with the plaintiffs' prior tax position. It would not be a return of the plaintiffs to the same position they would have occupied if they had never made the investment but merely an award of damages after crediting them with their tax benefits. In short, the "tax benefit doctrine" does not dictate the district court's decision but depends for its applicability upon the substance of that decision. To hold as the government urges would put the cart before the horse.

Lastly it has been suggested that the tax benefits should not be offset against the plaintiffs' investment because if there had been a full disclosure of Houston's intent to annex the land beneath the Greenspoint Project the Project would never have been built. This circular reasoning ignores the fact that the Project apartments have been built, triggering application of the tax incentives for investing in the costs involved, including financing, construction and operation. Although an increase in these costs might affect the price and ownership of the limited partnership units, depending on the investors' tax brackets and the tax benefits to be realized, there is no record evidence that the Project would not have been constructed if the City's prospective annexation had been revealed and no legal basis has been advanced for refusing to credit the plaintiffs with the tax benefits on the mere speculation that but for the alleged fraud the apartment complex would not have been built.

CONCLUSION

This appeal presents a classic example of the principle that a motion to strike should not be granted when there exist material issues that can only be resolved after the facts are known. Accordingly the order is reversed and the case remanded for further proceedings in accordance with this opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

WILLIAM Z. SALCER, et al.,	:	
Plaintiffs,	:	82 Civ. 5636 (VLB)
-against-	:	ORDER GRANTING PLAINTIFFS' MOTION TO STRIKE
ENVICON EQUITIES CORP., et al.,	:	CERTAIN AFFIRMATIVE DEFENSES OF THE
Defendants.	:	DEFENDANTS, ETC.

Plaintiffs' amended complaint in relevant part, alleges a violation of Section10(b) of the Securities Exchange Act of 1934, as amended, 15 USC § 78j(b) and SEC Rule 10b-5, 17 CFR 240.10b-5, promulgated thereunder, arising out of their purchase of securities in the form of whole or fractional limited partnership interests of Greenspoint Associates, a Texas limited partnership ("Greenspoint").

Defendants assert certain affirmative defenses in their respective answers alleging among other things, that plaintiffs did not suffer any damages because they received tax benefits and cash in excess of the amount of their investment. Pursuant to Rule 12(f) of the Federal Rules of Civil Procedure, plaintiffs moved to strike those affirmative defenses as being insufficient as a matter of law.

On December 9, 1983, David R. Simon, Esq. and Robert H. Jaffe, Esq., attorneys for the plaintiffs; Spengler Carlson Gubar Brodsky & Frischling (Thomas H. Sear, Esq., and Robert Knuts, Esq. appearing), attorneys for defendants Envitex Realty Corp., U.S. Southwest As-

sociates Turning Block Associates and Erving Wolf; Richard W. Schleiffer, Esq., attorney for defendants John W. Galston, Harry W. Burrow, Envicon Equities Corp., Envicon Development Corp. and U.S Properties/Southwest; D'Amato & Lynch (Dennis P. Costigan, Esq. appearing), attorneys for defendant Feit & Ahrens; Solinger Grosz and Goldwasser, P.C. (Bernard Persky, Esq. appearing), attorneys for defendant Blonder, Seymour & Shapps; and Suzanne Antippas, Esq., attorney for defendants William B. Bush, Jr. and Venture Development Group, Inc.; argued that motion before the Court;

And upon reading and filing the notice of motion for an order compelling production of documents of defendants Envitex Realty Corp., U.S. Southwest Associates, Turning Point Associates and Erving Wolf, the notice of joining in said motion by defendant Feit & Ahrens dated September 16, 1983, the affidavit of Thomas H. Sear, sworn to on June 22, 1983, the affidavit of Richard W. Schleiffer, sworn to on June 29, 1983, and the affidavit of Bernard Persky, sworn to on July 8, 1983, the affidavit of Suzanne Antippas, sworn to on June 29, 1983, and the affidavit of Thomas H. Sear, sworn to on September 23, 1983, and the affidavit of Dennis P. Costigan, sworn to on September 16, 1983, all in support of the motion of defendants Envitex Realty Corp., U.S. Southwest Associates, Turning Block Associates and Erving Wolf for an order compelling production of documents; the notice of motion to strike certain affirmative defenses of all defendants, dated August 29, 1983; the affidavit of Thomas H. Sear, sworn to on September 23, 1983 and the affidavit of Dennis P. Costigan, sworn to on September 30, 1983, in opposition to plaintiff's motion for an order striking certain affirmative defenses of all defendants; and all the memoranda of law submitted in regard to these motions;

And the Court having rendered an opinion made part of the transcript of the proceedings on December 9, 1983, and for other good cause shown:

IT IS on this day of January, 1984,

ORDERED THAT:

1. The following affirmative defenses of the defendants in this action are hereby stricken as defenses to the plaintiffs' claim under Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 USC §78j(b) and SEC Rule 10b-5, 17 CFR 240.10b-5, as being insufficient as a matter of law only insofar as they assert or may be construed to assert a defense that plaintiffs have suffered no damages because they received tax benefits and cash in excess of the amount of their investments in Greenspoint;

(a) the fifth and sixth affirmative defenses set forth in the answer to the amended complaint filed by defendants Envitex Realty Corp., U.S. Southwest Associates, Turning Block Associates and Erving Wolf;

(b) the fifth and sixth affirmative defenses set forth in the answer to the amended complaint filed by defendants John W. Galston, Harry W. Burrow, Envicon Equities Corp., Envicon Development Corp. and U.S. Properties/ Southwest;

(c) the tenth and twelfth affirmative defenses set forth in the answer to the amended complaint filed by defenddants William B. Bush, Jr. and Venture Development Group, Inc.;

(d) the seventeenth affirmative defense set forth in the answer to the amended complaint filed by defendant Feit & Ahrens; and

(e) the fifteenth affirmative defense set forth in the

answer to the amended complaint filed by defendant Blonder, Seymour & Shapps.

2. Notwithstanding the foregoing, defendants may show (a) there was a lack of reliance because of the impact that tax benefit expectations had on plaintiffs' decisions to invest in Geenspoint; and (b) that the alleged misrepresentations and omissions were not material in light of these tax benefits. The magistrate will determine the scope of discovery with respect to these and all other issues.

3. The decision set forth in paragraph "1" of this order is hereby certified to the United States Court of Appeals for the Second Circuit for review pursuant to 28 USC §1292(b) as involving a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of the litigation and otherwise result in saving the resources of the Court and the parties, and in streamlining further proceedings in this action.

4. Defendants have stated that they will file petitions for permission to appeal from this order and, for good cause shown, all proceedings in this action are hereby stayed pending a ruling by the United States Court of Appeals for the Second Circuit on those petitions and, if they are granted, pending a decision on the merits of the appeal from this order.

/s/ Vincent L. Broderick
VINCENT L. BRODERICK, U.S.D.J.

2/2/84

APPENDIX C

Section 28. (a) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security of any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

APPENDIX D

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 15th day of November, one thousand nine hundred and eighty-four.

WILLIAM Z. SALCER, PANFELD, EDELMAN, ET AL., a Texas General Partnership, ROBERT L. ANDREWS, M.D., SANJIVANI C. BAKARE, M.D., et. al.,

Plaintiffs-Appellees,

v.

ENVICON EQUITIES CORP., ENVICON DEVELOPMENT CORP., ENVITEX REALTY CORP., VENTURE DEVELOPMENT GROUP INC., a Texas Corporation, U.S. SOUTHWEST ASSOCIATES, a Texas General Partnership, et. al., No. 84-7183, -7185, -7187, -7189, 7191.

Defendants-Appellants.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the plaintiffs-appellees, William Z. Salcer, et. al.,

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

/s/ Elaine B. Goldsmith
Elaine B. Goldsmith
Clerk

APPENDIX E

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

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WILLIAM Z. SALCER and PANFELD, EDELMAN, et al.,

Plaintiffs,

- against - 82 Civ. 5636

ENVICON EQUITIES CORP., et al.,

Defendants.

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New York, New York
December 9, 1983, 2:00 p.m.

Before:

HONORABLE VINCENT L. BRODERICK,
District Judge

Appearances:

SIMON & ALLEN
Attorneys for Plaintiffs
BY: DAVID R. SIMON
-and-
JAFFE & SCHLESINGER, P.A.
BY: ROBERT H. JAFFE
Of Counsel

D'AMATO & LYNCH
Attorneys for Feit & Ahrens
BY: DENNIS P. COSTIGAN
Of Counsel

RICHARD W. SCHLEIFER
Attorneys for Envicon Equities,
Envicon Development Corp.,
John W. Galston, Harry W. Burrow
and U.S. Properties/Southwest

SOLINGER & GORDON, P.C.
Attorneys for Blonder, Seymour & Shapps
BY: BERNARD PERSKY
Of Counsel

SUZANNE ANTIPPAS
Attorney for Bush & Venture Development

SPENGLER, CARLSON, GUBAR, BRODSKY & FRISCHLING
Attorneys for Envitex Realty, U.S. Southwest Associates, Turning Block Assoc. and Erving Wolf
BY: THOMAS SEAR
ROBERT KNUTES
Of Counsel

THE COURT: I grant plaintiffs' motion to strike those affirmative defenses which in substance are predicated upon the plaintiffs having gotten the benefit of their bargain, because they did receive tax deductions.

I am not striking those defenses which assert that the plaintiffs did not rely upon the representations which are alleged to be false.

Those are in my judgment two very distinct matters, and the defendants will have the right to attempt to establish through discovery and then at trial that the plaintiffs, in investing in these so-called tax shelters, invested despite the omissions, irrespective of the omissions, and would have invested even if the admissions had not been made and the facts had been correctly stated.

There were two parts, as I see it, to the bargain that the plaintiffs received. One was the opportunity to receive currently available but probably rapidly wasting tax benefits or tax deductions or tax shelters.

The second part of the bargain was an investment in a capital resource that ultimately they, the investors, expected to increase in value.

As I understand the allegations in this action, they are that the defendants in inducing the participation of plaintiffs in this venture made certain representations with respect to the investment itself and the dimensions of the investment that were false, and that as a result of that falsity, the investment itself was necessarily terminated at an early date.

This affected a complete cutoff of the expectation that the investors had that they did in fact have a capital investment which ultimately would appreciate in value and ultimately produce income.

During the colloquy which we had, Miss Antippas pointed out that there could very well have been another type of fraud alleged, a fraudulent representation that something was a tax shelter when in fact it was not a tax shelter, and because it was not a tax shelter, ultimately the investors who attempted to take advantage of it, had to regorge the advantage that they took to the government.

This, as I see it, is not that situation. This is a situation where the allegations go to the investment itself and not to its attributes of being a tax shelter.

There is, as the documents which you have filed and the memoranda you have filed indicate, a difference of opinion as to whether in the tax shelter type situation where 10(b)(5) type allegations are made, consideration should be given to the tax benefits received by the plaintiffs in determining the extent of their damage, and it was suggested by one or more of the courts that considered it, that

something in the nature of Alice in Wonderland is involved in those tax considerations, are not taken into account.

I certainly do not intend to indulge in Alice in Wonderland, but it seems to me that the tax considerations come into this case in determining whether there was in fact a fraud committed.

The plaintiffs have argued that since the frauds alleged are frauds of admission, reliance need not be shown, and I think as far as it goes that that is a correct statement of the law.

But it is certainly open to the defendants to show affirmatively that there was a lack of reliance, and the defendants in this case may attempt to establish that there was no fraud by showing affirmatively that there was a lack of reliance on the part of one or more of the plaintiffs here on these statements.

Now, I would assume they will attempt to show this by showing that the prime motivation to the plaintiffs in making this investment were the tax shelter considerations, and so by granting plaintiffs' motion to strike affirmative defenses here, I am not by any means putting out of the case the consideration of what impact, if any, tax benefit exceptions may have had in persuading the plaintiffs to invest.

As a matter of logic, it makes no sense to me, and I am now getting back to my reasons for striking the affirmative defenses, as a matter of logic it makes no sense to me to say that a fraud committed on an investor by selling him an interest which was not worth what it should have been worth if the fraud had not been committed or if the investment was as it was represented to be, it makes no sense to say that any loss to the defrauded investor and

hence, any gain or recovery which he is entitled to should be reduced by the tax benefits that he has realized.

Those tax benefits would have been realized whether or not there was a fraud in this particular situation.

And it is not the presence of those tax benefits or any absence of those tax benefits that is complained about. It is something quite different that is complained about.

It is the disappearance of an investment which was supposed to carry on and become profitable that is being complained about.

The investor who was interested in tax considerations when he invested here could very well have invested in some entirely different company, realized comparable tax benefits, and not suffered the loss that the investors here are alleged to have suffered because of the fraud.

I can actually see no basis upon which a recovery for this fraud should be tempered by an expected tax benefit which would have been there whether or not there was a fraud or should have been there whether or not there was a fraud, and which would have been equally available in any other investment.

Now, gentlemen and ladies, that is my ruling with respect to the plaintiffs' motion to strike defenses. I am going to ask counsel to submit an order on this matter because I would like counsel to consult with one another as to just which of the affirmative defenses is implicated in this ruling.

We will be dealing among other things with Envicon's fifth and sixth defenses, with Feit and Ahrens, I believe its sixth and seventeenth defenses, with Blonder's fifteenth defense, and there is one other, I believe. Well, some of

those defenses that the motion was specifically addressed to may have shaded over into this other area that I have talked about. In other words, they may have shaded over into the area of being an affirmative defense against the allegation of fraud itself, because they are alleging the absence of a second element of reliance, and that's why I would like to ask you to agree on the defenses which have been stricken here.

I think I have made it fairly clear which ones I intend to strike.

So far as the motion with respect to discovery of the plaintiffs, I think my ruling makes it clear that I do not consider that tax information from the plaintiffs is irrelevant to the further progress of this case because it may very well be germane to questions of a particular plaintiff's reliance.

But I have confided to Judge Raby the responsibility for supervising discovery, and consistent with this ruling, I will expect him to continue to do that. He can make his own judgment after due consultation with you gentlemen and ladies, and after proper suggestions from you as to whether the production of tax returns is necessary or whether information can be given, or whether a protective order should be developed. I leave all this to his good judgment.

Does that leave anything open before me?

Yes, sir?

MR. JAFFE: Just one thing.

I don't know, since we won, we wouldn't appeal but if the defendants intend to appeal whether we shouldn't —

THE COURT: Thank you very much. I did mean to say that.

I am not urging anyone to appeal, but if there is to be an appeal here, I certainly believe it would be proper to include in my order a provision under, I believe it is 28 U.S.C., Section 1292, the issue involved here is a crucial issue in this case. It may very well determine whether this case is to proceed or not to to [sic] proceed. It is, so far as I know, a matter of first impression in this district and certainly in this circuit.

Is that responsive to your suggestion?

MR. JAFFE: It certainly is, your Honor, and if counsel agree, certainly defendants indicated interest in appealing, maybe we will work a question to be presented to the Second Circuit on it.

THE COURT: Very well. Thank you.

MR. JAFFE: Thank you very much.

MS. ANTIPPAS: Thank you.

MR. SEAR: Thank you very much, your Honor.

APPENDIX F

Excerpts from Transcript of Oral Argument before District Judge Vincent L. Broderick, December 9, 1983

MR. JAFFE: Your Honor, this hearing comes on, I believe, in effect in response to the memorandum and order of Magistrate Raby on October 12, 1983, where the magistrate suggested that the Court consider the motion to strike affirmative defenses of the defendants relating to the issue of damages in this case, noting at page 2 that counsel for the plaintiffs, and commenting on the affirmative defense, that tax benefits should be used to reduce the damages in this matter.

And as a result thereof, assuming a 50 percent tax rate for each of the named plaintiffs, an assumption which we accept as true for purposes of this motion, that such a holding would mean effectively that the federal government subsidizes fraud. And that is the essence.

* * *

THE COURT: Well, now your interest in dismissing these affirmative defenses at this point is because you don't want to turn over your clients' tax returns, is that not right?

MR. JAFFE: That's not correct, your Honor.

THE COURT: What other interest can you possibly have?

MR. JAFFE: Because, your Honor, the interest in dismissing is to determine whether we should go forward with this case, because if in fact the Court determines that tax benefits, as a matter of law, are to be deducted from

claims made by our clients, it would be our recommendation to our clients that this case is not worth a candle, and we want to be in a position to recommend that.

Because while there may be one or two of the named plaintiffs, due to circumstances beyond their control, that after the year 1977 had experienced such financial difficulty that they could not take the benefits they anticipated taking when they went into this venture, they may have a small claim left even after you take into account the tax benefits. Most of them will not be in that position. Most of them, we submit to the Court, went into this, there is no question about it, went into this investment based in part that they were in a tax bracket where the tax benefits would be significant to them.

So our reason is not simply because we do not want them to turn over their tax returns. Our reason as to whether or not they should go through a litigation, which is still in its inception, which still has a great deal of discovery to be taken from a great number of defendants and, undoubtedly at some point from the plaintiffs, substantial number of plaintiffs, 20 individuals here, whether it is worth their time and effort to go through it because if one or two of them, they have a two or three or $4000 net claim remaining after you apply tax benefits, it may not be worth it to them.

* * *

MR. JAFFE: Your Honor, we have a record. I submit we have a record. I submit that we have agreed with the factual presentation made by the defendants.

I submit that we will stand and stipulate on behalf of our clients that they went into this matter because as represented in a subscription to this limited partnership, they represented that they were 50 percent taxpayers.

There is no question but that they also, among other things, relied upon the fact that this was a tax shelter. We don't dispute it.

For the purposes of this motion, we submit to the Court the defendants are correct as to their factual assumptions. So there is a record here.

A stipulaton of counsel is as much a fact as anything else in the record. We stipulate that because we stipulate — we make the reasoning for our stipulation even more strong — that we have to go back and advise our clients. We have to advise them if there is any value to it, and we have submitted we are going to advise them there is no value to this case, because taking the facts as stated by the defendants in their motion to obtain the tax returns, they are correct.

* * *

In this particular case, the net claim of each of the plaintiffs is exact. We have the amount. They invested $77,500 for a whole unit, a couple of people bought two units, one person bought a fraction of a unit, but the unit was $77,500.

At the time of the forced sale, they obtained a refund of $30,000. That too was reflected appropriately in the schedule prepared by the defendants, and we agree. It's correct. So their loss is now established at $47,500.

However, by virtue of the tax benefits which they obtained, they actually all ended up, assuming the 50 percent tax bracket, with a profit. Assuming that benefit, actually their tax benefits, even at a 50 percent rate, exceeded the $47,500.

So it's not a question of whether there is a factual record here, your Honor.

* * *

THE COURT: Once you decide he went into this for tax benefits, then, the more the fraud, the more the benefits, so he has no recovery.

MR. SEAR: That may or may not be true. I don't think that that's necessarily true, because there are — perhaps the misrepresentations in the hypothetical situation that you are talking about would cause him so much economic loss on an overall basis, the investor would suffer real economic loss.

So what we are saying here is, I think Mr. Jaffe, in his argument, really made the point for us when he said there was no loss.

THE COURT: I don't know how your [sic] answering his argument at all. He is saying, "We have a case here where there is a very, very clear-cut issue of law that has never been decided in this court, never been decided in this circuit, and that the factual record could not be any clearer than it is right now because you have made allegations in your papers that there was an investment, I think of —

MR. SEAR: 77,000.

THE COURT: 77,000. That they realized 40,000, and that they got tax benefits of 67,000. So that they come out with a net plus of, I think, about 20,000. And you allege that in your papers, and you set out your arithmetic and the plaintiff says he is absolutely right. That is setting out in stark form, which we agree to, just what the economic situation is here, that because of the tax benefits, our clients did not actually economically overall lose money.

They made $20,000. But they say you can't do that. You can't consider the tax benefits.

You say, of course, you consider the tax benefits. They say it's a question of law, and we are going to spend two years on discovery here. If they are right, this case goes away.

MR. SEAR: Well, I would submit that that sort of actual concession combined with their legal position does not provide a proper basis for a motion to strike affirmative defenses.

THE COURT: Well, forget about whether it's for a motion to strike affirmative defenses or not. It really turns a motion to strike affirmative defenses into sort of a motion for summary judgment because the facts that would underly them, your argument against striking affirmative defenses is that you shouldn't do it early in the case, and it's a pure question of law.

They say, "Well, we have the underpinnings of the facts there. There is a pure question of law with that underpinning of facts, and it's just like a motion for summary judgment addressed to an affirmative defense.

* * *

THE COURT: See, the people who invested — my logical problem with your position, my logical problem with the court in the Eighth Circuit is that you just can't look at this and say, what was the loss on a netting basis, netting the cash loss against the tax gain, because the people who came into this thing, they did not have a question of coming into this or not coming into it.

They had the question of coming into this tax shelter or some other tax shelter, and whatever tax shelter they went into they were going to get a tax benefit.

And what they are complaining about here is, and they may have a difficult job of proving this, that there was a net principal loss because of the fraud of the defendants. And your argument and the Eighth Circuit's position that you net tax benefits against a fraudulently induced loss just makes very little sense to me.

There is no transaction that anybody enters into that doesn't have — that doesn't have tax considerations. There may not be very many that are sold as hard as this type is sold because of the tax considerations, but it is sort of unique, it seems to me, to be saying that in this one area, we will look at the tax benefits.